

memorandum

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G:\WPDOCS\ADVISORY [REDACTED]



date: JUN 29 2000

to: Examination Division
Attn: Bill Leary
Revenue Agent

from: District Counsel
Central California District

subject: [REDACTED]
TL-N-2406-00

This memorandum is written in response to the request for assistance in the above-referenced matter which we received from your office. This advisory opinion constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the recipient of this document may provide it only to those persons whose official tax administration duties require such disclosure. In no event may this document be provided other persons beyond those specifically indicated in this statement. This memorandum may not be disclosed to taxpayers or their representatives other than as indicated herein.

This advice is not binding on Examination or Appeals and is not a final case determination. This advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

This advisory opinion is written in response to your memorandum, dated April 10, 2000, requesting our opinion of whether certain expenditures of [REDACTED] ("the Taxpayer") are required to be capitalized pursuant to I.R.C. § 263A or whether such expenditures are deductible research and experimental expenses pursuant to I.R.C. § 174. After informally consulting with our National Office, we recommend that the Taxpayer's claimed research expenses be disallowed for the reasons set forth below.

FACTS

The Taxpayer's principal trade or business is the sale and distribution of sport footwear. This footwear is used in hiking, cycling, swimming and running, as well as many other sporting activities. The Taxpayer's design and prototype department is engaged in the design, development, product modification and improvement of the footwear.

In general, the activities in question begin with the Taxpayer's design team drawing pictures of how next year's product line should look. Numerous pictures are drawn for each of the varieties of footwear the Taxpayer sells. Some of the drawings and ideas are discarded and others are kept as potential product designs. Eventually through this process of drawing, redrawing and modification of appearance, certain ideas and concepts are identified as being the basis for next year's product line. This design phase may be as simple as changing the color of a product or the moving of the corporate insignia from one spot on a particular product to another. However, it may be as complex as designing an entire new line of footwear.

After a decision is made regarding next year's product line, the design team discusses its recommendations with management and they are either approved or rejected. Communication between the design team and management is an ongoing process. Once viable products are identified, the design and prototype team determine the components and how the products will be manufactured. The Taxpayer does not manufacture the components itself, but rather it identifies the best components available in the marketplace.

Once it is agreed upon to use a particular or combination of components in the manufacture of a design, the design and prototype department determines how the product will be constructed. After agreement is reached on what components will be used, how they will be used and how the product will be constructed, the Taxpayer has pairs of the product constructed by a foreign shoe manufacturer (i.e. the Taxpayer does not manufacture its own footwear).

When the Taxpayer receives the [REDACTED] sample pairs, they are inspected for inherent design flaws. Once the Taxpayer is satisfied that the shoes are marketable, the [REDACTED] pairs are distributed to its sales force. The product is then taken to the Taxpayer's customers for potential orders. If orders for a product reach a certain level, the Taxpayer submits an order to its manufacturer for further production of the product. If orders do not reach a certain level, the Taxpayer abandons the product. Accordingly, the risk of uncertainty is not whether or not products can be successfully modified, but rather whether the product can be marketed profitably after the decision to manufacture the product is made.

The Taxpayer does not have an internal testing laboratory to determine whether its potential products will stand up to the rigors of usage. Instead, the Taxpayer relies on the ultimate consumer to test its products after purchasing them. The Taxpayer learns whether there are flaws in the design, the components and/or their usage, when consumers return products to stores where they were purchased. If a certain product line has a problem which can be corrected, for example the soles of a shoe should be sewed rather than glued or the tread of a product needs to be redesigned, the design and prototype department will study the methods in which the problems can be corrected and the product modified and improved. Again, this modification and improvement may be as simple as changing the color or moving the corporate insignia or as complex as redesigning a component or altering the construction of the entire product.

The Taxpayer's accounting for the costs incurred by the design and prototype department does not allow for identification as to the products, successful or unsuccessful, which were worked on, the modifications or improvements which were undertaken or the specific activities that were undertaken by the design and prototype department and its employees. The Taxpayer classified all of the costs of this department as deductible section 174 expenses regardless of whether the design change was merely a change in the color or whether the change involved an entirely new product (all costs were deemed by the Taxpayer to be research and development expenditures incurred in a experimental or laboratory sense).

Finally, although the members of the design and prototype team are talented artists, they do not have degrees in manufacturing, construction, production, engineering or any advanced degree which could be used to further the advancement of technology of basic footwear and its construction.

ANALYSIS

I.R.C. § 174 provides that research or experimental expenditures paid or incurred during the taxable year in connection with a taxpayer's trade or business may, at the taxpayer's election, be deducted currently rather than capitalized. The regulations define the term "research or experimental expenditures" as expenditures that represent research and development costs in the experimental or laboratory sense. The term generally includes all such costs incident to the development or improvement of a product. Treas. Reg. § 1.174-2(a)(1). The term "product" includes, in relevant part, any pilot model, formula, invention, technique, patent, or similar property. Treas. Reg. § 1.174-2(a)(2).

"Expenditures represent research and development costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product." Treas. Reg. § 1.174-2(a)(1). Further, whether expenditures qualify as research or experimental expenses depends upon the nature of the activity to which the expenses relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents. Treas. Reg. § 1.174-2(a)(1).

While the Code and regulations do not specifically define the term "research or experimental expenditures," the regulations do provide certain exclusions.

Expenses explicitly excepted from the definition of research or experimental include, in relevant part:

- (1) expenditures for ordinary testing or inspection of materials or products for quality control;
- (2) expenditures for efficiency surveys, management studies, consumer surveys, advertising, or promotions; and
- (3) expenditures in connection with literary, historical, or similar projects.

Treas. Reg. § 1.174-2(a)(3).

An important distinction is drawn in the regulations between scientific research and research of other types. Specifically, expenditures for research that are not intended to discover information that would eliminate uncertainty concerning the development or improvement of any pilot model, process, formula, invention, technique, patent, or similar property will fail to constitute research or experimental expenditures for purposes of section 174. See Treas. Reg. § 1.174-2(a). Indeed, the distinction in the regulations between social science research and research in the traditional scientific or laboratory sense appears reasonable in light of the legislative history of I.R.C. § 174 which suggests that expenditures related to research in areas other than the traditional scientific fields should not be deductible.

In considering the definition of research in I.R.C. § 174, the Tax Court found it to be "consistent with the intent of the statute to limit deductions to those expenditures of an investigative nature expended in developing the concept of a model or product." Mayrath v. Commissioner, 41 T.C. 582, 590 (1964), aff'd, 357 F.2d 209 (5th Cir. 1966). See also, Kollsman Instrument Corp. v. Commissioner, T.C. Memo. 1986-66, aff'd on other grounds, 870 F.2d 89 (2d Cir. 1989) (denying section 174 treatment because the contracts in question did not require the taxpayer to invent, develop the concept of, or design any product); Agro Science Co. v. Commissioner, T.C. Memo. 1989-687, aff'd but opinion withdrawn, 927 F.2d 213 (5th Cir. 1991) (finding that research requires an element of experimentation rather than simply a repetition of what has already been done); and, TSR, Inc. and Subsidiary v.

Commissioner, 96 T.C. 903 (1991) (examining, for section 41 research credit purposes, such terms as "laboratory" and "experimental" under section 174).

The facts of this case suggest that the expenditures in question do not represent research and development costs in the experimental or laboratory sense. In the process of selecting a design for next year's product line, the design team members draw and redraw pictures of the various footwear, until management approves a particular design for a particular shoe. The design team members are talented artists, however they are not engineers or podiatrists nor do they have advanced technical degrees. Further, the Taxpayer does not internally test the model shoes' function and/or performance. All of these facts suggest that the nature of this type of activity is not research and development in the experimental or laboratory sense. Therefore, we believe that such expenses are not deductible under I.R.C. § 174. However, to the extent that the expenditures are related to potential modifications/revisions involving the components of the shoes or the manufacturing process rather than merely the appearance of the shoes, such expenditures *may be* deductible under I.R.C. § 174.

CONCLUSION

Based on the analysis set forth above, we believe that the Taxpayer is required to capitalize the expenditures at issue. If you have any questions on this matter, please contact the undersigned at (408) 817-4667.

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